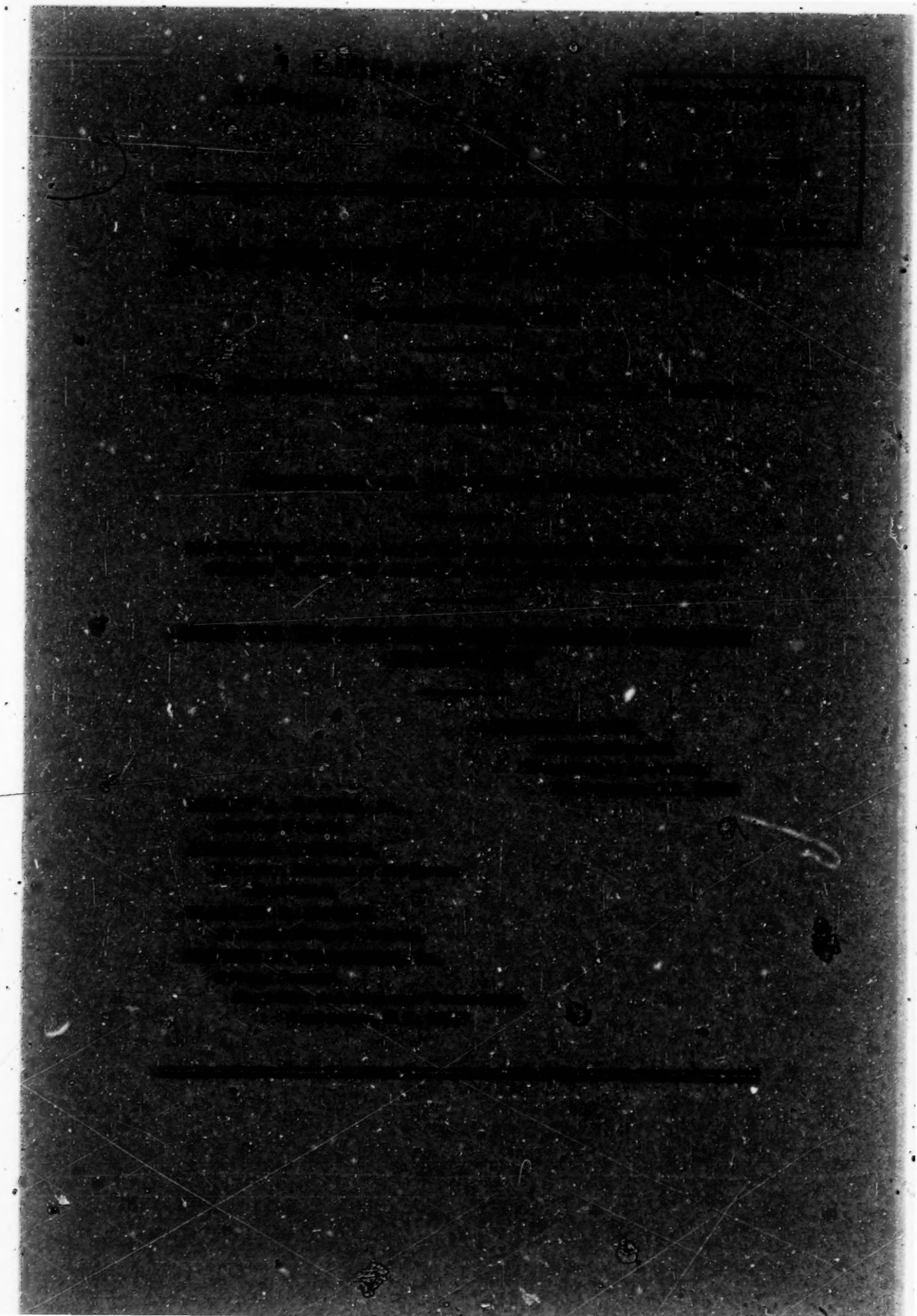

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731-004—64

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 1001

THE PRUDENTIAL INSURANCE COMPANY OF AMERICA, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a–10a) is reported at 326 F. 2d 383. The findings, opinion, and order of the Commission (Pet. App. 11a–45a) are not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on January 20, 1964, and the petition for a writ of certiorari was filed on April 14, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the holding in *Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co.*, 359 U.S. 65, that the Investment Company Act of 1940 applies to the business of selling variable annuity contracts, *i.e.*, annuities which are not fixed in amount but vary in accordance with the investment experience of a fund of equity securities, applies to such a business when it is conducted by a company primarily engaged in selling life and disability insurance.

STATUTE INVOLVED

The pertinent provisions of the Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C. 80a–1, *et seq.*, are set forth in the Petition at pp. 2–4.

STATEMENT

The petitioner is a large mutual company engaged in the life and disability insurance business (Pet. 11a, n. 3). On February 28, 1961, it filed with the Securities and Exchange Commission an application for an order declaring that its proposed sale of variable annuity contracts would not subject it or its variable annuity "Investment Fund" to any of the provisions of the Investment Company Act of 1940 (Pet. 11a).[1]

The basic facts respecting the proposed variable annuity contracts are not in dispute. The Commission described the arrangements as follows (Pet. 12a–14a, footnotes omitted):

[1] Alternatively, the petitioner sought exemption from various requirements of the Act (Pet. 11a, 30a–31a). The Commission granted some and denied the remainder of these request (Pet. 31a–42a), and petitioner did not seek judicial review of the denials (Pet. 9–10).

* * * the purchaser will make monthly purchase payments of fixed amounts over a period of years (the "pay-in" period), the proceeds of which, after certain deductions, will be invested in a portfolio of securities. The purchaser will be credited monthly with "units" representing his proportionate interest in this fund. The value of these units will fluctuate, essentially depending upon the investment results of the fund. During the annuity, or "pay-out" period, Prudential guarantees that the purchaser will receive in cash the varying value of a fixed number of units as monthly annuity payments.

Specifically the payments made by the purchasers will be placed in a "Variable Contract Account" which will be managed by Prudential and be sub-divided into two accounts. The first, the "Investment Fund" account, will have its assets invested primarily in common stocks and will constitute the fund in which the purchasers hold units; this account will be dedicated solely to the variable annuity contract holders and its assets will not be subject to claims of any other contract or policyholder of the company. The second, the "Other Assets" account, an administration account, will receive the amounts deducted from the purchase payments to cover administration expenses, sales commissions, and certain taxes, and to provide a surplus or reserve for the obligations to purchasers contained in the contracts. * * *

During the pay-in period a purchaser will have the right to terminate the contract and receive the value of all units credited to his

account, less certain termination charges. If a purchaser should die during the pay-in period, the contract is automatically terminated and his beneficiary is paid the greater of (i) the value of all units credited to the purchaser's account or (ii) an amount equal to the total of all purchase payments made.

Absent death or redemption, the pay-in period normally runs for at least 15 years. Thereafter, during the pay-out period, the variable annuitant is entitled to receive each month the current value of a fixed number of units determined at the end of the pay-in period. This number of units is calculated on the basis of the number of units accumulated by the purchaser during the pay-in period, an assumed annual investment increment of 2½% from dividend and interest income, and actuarial computations which take into account the length of the pay-out period anticipated in light of the age and sex of the purchaser and any co-annuitant. The value of the variable unit during the pay-in and pay-out periods will be determined at the end of each month and will reflect the changes in the market value of the securities in the Investment Fund account, realized gains and losses, and dividend or interest income. * * *

After full administrative proceedings, the Commission held that the Act applies to petitioner's activities in selling variable annuity contracts. The Commission stated (Pet. 15a) that petitioner, "because of the predominant nature of its insurance business, is an insurance company as defined in Section 2(a)(17) of the Act and, as such, excepted from

the definition of an investment company under Section 3(c)(3)." Noting that Section 2(a)(8) of the Act defines company to include "a trust, a fund, or any organized group of persons," the Commission ruled that petitioner's variable annuity contracts created all three of these entities (Pet. 23a). It concluded (Pet. 17a, footnote omitted) that although petitioner "is not itself an investment company"

> it is the creator of one—and proposes to be its "investment adviser" and "principal underwriter." That an exempt insurance company performs these functions is irrelevant. The Act's exclusion of insurance companies is to be readily explained: otherwise they would fall within the statute by reason of the investment activities which are a necessary ingredient of their insurance business. Where, however, an insurance company (or any other entity) creates a fund exclusively for investment, and sells equity interests in the fortunes of that fund, the exemption does not carry over to the fund. * * *

The court of appeals affirmed. On the basis of the language, legislative history and purpose of the Act, it agreed with the Commission that "Prudential's Investment Fund is a 'fund' as that term is used in the statute" (Pet. 7a), and that "the Investment Fund, and not Prudential, is the 'issuer' of these securities for the purposes of the Investment Company Act of 1940" (Pet. 8a).

ARGUMENT

In *Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co.* ("*VALIC*"), 359 U.S.

65, this Court held that companies which, although incorporated under a life insurance company statute, engaged primarily in selling variable annuity contracts, are subject to regulation under the Investment Company Act, because such contracts are not "contracts of insurance" and the Act's exemption for insurance companies is therefore inapplicable.[2] The question in this case is whether a variable annuity business, when conducted by a company which is itself exempt from the Act because it is an insurance company, is subject to the Act. Although the question is significant to the segment of the life insurance industry which might like to enter the variable annuity field, the decision below holding the Act applicable to an "Investment Fund" which consists of a pool of equity security interests of variable annuity contract purchasers is plainly correct, and there is no occasion for further review.

1. In *VALIC* this Court, although recognizing that "[i]n some respects the variable annuity has the characteristics of the fixed and conventional annuity" (359 U.S. at 70), concluded (*id.* at 71) that it lacks one of the basic elements of the "concept of 'insurance'": that there be "some investment risk-taking on the part of the company." It noted (*id.* at 71–72, footnotes omitted) that "absent some guarantee of

[2] Section 3(c)(3) provides that an "insurance company" is not an investment company, and Section 2(a)(17) defines "insurance company" as "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State * * *."

fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. * * * The companies that issue these annuities * * * guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor."

Mr. Justice Brennan, in his concurring opinion (in which Mr. Justice Stewart joined) further developed the policy considerations establishing that a variable annuity contract is not "within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners" (*id.* at 76). He pointed out (*id.* at 79) that the various regulatory controls in the Investment Company Act "are of particular relevance to situations where the investor is committing his funds to the hands of others on an equity basis, with the view that the funds will be invested in securities and his fortunes will depend on the success of the investment"; and that "[t]he traditional state insurance department regulation of contract terms, reserves, solvency, and permissible investments simply does not touch the points of definition of investment policy and investment technique, and control over investment policy changes and over the interests of the men who shape the policies of investment and furnish investment advice that the 1940 Federal Act provides." Justice Brennan noted (*id.* at 85–86) that "what the investor is participating in during this [pay-in] period * * * is something quite similar to a conventional open-end management investment company, under a periodic investment plan"; and that "the detailed protections of the 1940

legislation—disclosure of investment policy, regulation of changes of that policy, of capital structure, conflicts of interest, investment advisers * * * are the basic protections that Congress intended investors to have when they put their money into the hands of an investment trust; there is no adequate substitute for them in the traditional regulatory controls administered by state insurance departments, because these controls are not relevant to the specific regulatory problems of an investment trust." [2] He further pointed out (*id.* at 88) that during the pay-out period, the investor "is in almost every way as much a participant in something equivalent to an investment trust as before"; [3] and that "[i]t is not rational to say that Congress abandoned the very appropriate protections of the Investment Company Act in this investor's case in favor of provisions of state regulation that are quite irrelevant to the basic problems of protecting him" (*id.* at 89).

These considerations are equally applicable to variable annuity contracts here involved, and they similarly

[2] Indeed, at this stage the investor cannot, as during the pay-in period, withdraw his investment if he becomes dissatisfied with the way his money is being managed. It is therefore particularly important that he should then have the right, as he does under the Investment Company Act, to govern investment policies and to select the persons who are going to do his investing for him at his sole risk. Petitioner's arguments against application of the rights granted to investors by the Investment Company Act—for example, that under Section 15 of the Act the variable annuitants "would be free * * * to choose a rival insurance company as [their] investment advisor after giving only 60 days notice" (Pet. 17)—could be made equally well by the sponsor of any mutual fund that is registered under the Act.

compel the conclusion that this phase of petitioner's business, like the business involved in the *VALIC* case, is also subject to the Act. The "detailed protections of the 1940 legislation * * * that Congress intended investors to have when they put their money into the hands of an investment trust" (*VALIC*, concurring opinion, 359 U.S. at 85) are no less necessary merely because an investor purchases his variable annuity contract from an insurance company primarily engaged in selling life insurance rather than from one primarily engaged in selling such contracts. The significant consideration is not the percentage of the issuer's business that it derives from selling variable annuity contracts, but the basic character of those contracts and the fact that the traditional State regulation of insurance cannot give purchasers the kind of protection that Congress intended to provide "where the investor is asked to put his money in a scheme for managing it on an equity basis * * *" (*id.* at 80).

2. In the light of these factors, the Commission and the court of appeals correctly rejected the contention that because petitioner, as an insurance company, is generally exempt from regulation under the Investment Company Act, its variable annuity business is similarly exempt. As shown above, the consideration which led Congress to provide an exemption for insurance companies—that State regulation of their usual activities was fully adequate to protect policyholders—is inapplicable where such companies sell variable annuity contracts whose vital characteristic (participation in a pool of equity investments) requires a very different kind of regulation which only the federal statute provides.

The agency and the court correctly held that the statutory definition of investment company covers the Investment Fund through which petitioner would operate its variable annuity program. Section 2(a)(8) of the Act (Pet. 4) broadly defines "company" to include "a trust, a fund, or any organized group of persons whether incorporated or not." As the court below noted (Pet. 8(a), footnote omitted):

> the Investment Fund is a completely segregated account, devoted to investing in securities. The cash for these investments is derived from payments made by the purchaser of the variable annuity contract. Though the proceeds of the fund are held for the sole benefit of the annuitant, it is this fund, and no other entity, in which he has an interest. Thus, the fund is separable from the insurance company which, as the Supreme Court noted in VALIC, "guarantee[s] nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor."

In sum, the only interest the holder of a variable annuity contract has is in the Investment Fund; he has no interest in petitioner's assets which are employed in conducting its life and disability insurance business.[1] The legislative history indicates, as the court of appeals noted (Pet. 7(a)), that

[1] If the actuarial assumptions underlying the variable annuities proved to be so inadequate that the "Other Assets" account were completely exhausted, the variable annuitants would then have a claim upon Prudential's assets generally. But this appears to be an academic point. The actuaries of both Prudential and the State of New Jersey stressed that such possibility is extremely remote (J.A. 117a, 120a).

Congress intended to regulate the "large liquid pools of the public's savings entrusted to managements to be invested."[5] The court below (as did the Commission) correctly treated the Investment Fund, and not Prudential, "[a]s the issuer of these securities for the purposes of the Investment Company Act of 1940." (Pet. 8(a), 17(a), 23(a).)

Petitioner seeks to avoid the compelling force of this reasoning by urging (Pet. 15) that, since compliance with the Act would require it to take various steps which it considers unwieldy and unduly expensive, the effect of the decision below "is to deny to existing life insurance companies the right to issue and sell variable annuities to the public." The full answer to this contention was given by Mr. Justice Brennan in his concurring opinion in *VALIC* where, in rejecting a similar argument, he pointed out (359 U.S. at 92-93): "it is not decisive of the issues here that a holding that these contracts are subject to the Federal Acts might require some modification in the business of issuing them. Since these contracts are in fact covered by the Acts, there can be no reason why their issuers should be able to carry on the investment business in a way which Congress has forbidden." Moreover, if, as petitioner states (Pet. 17-18), compliance with the Investment Company Act would require further changes in the New Jersey insurance law, there would appear to be no reason why the State legislature, which has already amended the

[5] H. Rep. No. 2639, 76th Cong., 3d Sess., p. 6; Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 76th Cong., 3d Sess., on S. 3580, p. 33.

law once to enable petitioner to sell variable annuity contracts (Pet. 6), would not do so again.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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